IT 00-27
Tax Type: Income Tax
Issue: Unitary – Inclusion of Company(ies) In A Unitary Group

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
ADMINISTRATIVE HEARINGS DIVISION
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS,	**No: 00-IT-0000 (consolidated)**
v.	**FEIN: 00-0000000**
THE "MONTROSE" CHEMICAL CO.,	
Taxpayer	

RECOMMENDATION FOR DISPOSITION

Appearances: Mr. Thomas Linguanti, of Baker & McKenzie for The "Montrose" Chemical Company; Ms. Katherine Michaelis, Special Assistant Attorney General for the Illinois Department Of Revenue.

Synopsis:

There are three issues in this matter: 1) whether The "Montrose" Chemical Company ("MCC") is engaged in a unitary business with "Minnesota Multiphasic Montrose", Inc. ("MMM"), and its subsidiaries, which includes a fully owned subsidiary "Multiphasic Montrose Pharmaceutical", Inc. (""MMP"") and its subsidiaries, during calendar years 1990 through 1993; 2) whether certain capital gain and dividend income was business income for the years 1988 through 1990; 3) whether taxpayer is entitled to

abatement of penalties imposed pursuant to 35 ILCS 5/1005 for the years 1988 through 1990.

Findings of Fact:

1. "MCC" timely filed its Illinois income tax returns for the tax years ending December 31, 1988 through December 31, 1993. On its 1990 through 1993 returns, "MCC" did not include "Minnesota Multiphasic Montrose", Inc. ("MMM") and "MMM's" wholly owned subsidiary, "Multiphasic Montrose Pharmaceuticals", Inc. (""MMP""), in "MCC's" "unitary business group," as defined in §1501(a)(27). In addition, "MCC" classified certain dividends and capital gains as "nonbusinesss income," under §304. Stip. ¶ 1.
2. After auditing "MCC's" 1988, 1989, and 1990 Illinois income tax returns, the Department issued a Notice of Deficiency to "MCC" on October 14, 1992, asserting a $1,782,825 deficiency (the "1988-1990 Notice"). The 1988-1990 Notice asserts, in part, that "MCC's" unitary business group should include "MMM" and its subsidiaries, including ""MMP"". The 1988-1990 Notice also reclassified as "business income" certain dividends and capital gains received by "MCC" as a result of its ownership or sale of shares of stock. Stip. ¶ 2.
3. The Department also issued Notices of Deficiency to "MMM" and to ""MMP"" on October 14, 1992. The Notice to ""MMM"" asserts a $370,690 tax deficiency and asserted penalties under §1005 for "MMM's" alleged failure to file an Illinois income tax return for 1990. The Notice to "MMM" indicates that the Department determined that "MMM" "and a certain number of [its] related corporations conducted a 'unitary business'" during 1990. The Notice of Deficiency issued to ""MMP"" asserts a $91,770 tax deficiency for 1990. Stip. ¶ 5. The Department issued a Notice of Denial

to "MCC" on January 26, 1996, for the 1990 tax year, concerning "MCC's" claim for refund arising from, among other things, net operating losses that it sought to carry back to 1990. Stip. ¶ 3.

4. "MCC" and ""MMP"" timely protested the 1988-1990 Notice, the Notice of Denial, and the Notice to ""MMP"", respectively, and each protested matter was consolidated and assigned Docket No. 93-IT-0400 (the "1988-1990 case"). Stip. ¶ 6.

5. On March 8, 1996, the Department issued a Notice of Deficiency to "MCC" for 1991, 1992 and 1993, in which the Department asserted a $3,865,054 deficiency (the "1991-1993 Notice"). The deficiency was based, in part, on the Department's determination that "MMM" and its subsidiaries, including ""MMP"", should be included in "MCC's" unitary business group. Stip. ¶ 10.

6. "MCC" is a Delaware corporation with its principal place of business in (Some City), (Some State), and is the common parent of a group of subsidiaries that elected to file consolidated Federal income tax returns during the years at issue. "MCC" and "MMM" did not file consolidated Federal income tax returns during the relevant tax years, 1990 through 1993. However, "MMM" did include ""MMP"" on its consolidated Federal income tax returns. Stip. ¶ 14.

7. "MMP" was created in 1981, when a newly created subsidiary of "MCC" merged with "Wiley Multiphasic, Inc". ("WMI"). WMI had been engaged in the manufacture and marketing of (i) prescription and ethical over-the-counter pharmaceuticals and medicines and (ii) consumer health products and toiletries, and chemical, diagnostic, nutrition, and wood care products. Stip. ¶ 15.

8. “MMP” took over “WMI’s” prescription and ethical over-the-counter pharmaceutical business; the remainder of “WMI’s” former business was spun-off and was not part of “MMP”. Stip. ¶ 16.
9. “MMP” was a Delaware corporation with its principal place of business in (Some City), Ohio. Stip. ¶ 17.
10. From March 1981 to December 1989, “MCC” directly or indirectly owned 100 percent of “MMP’s” outstanding shares of stock. Stip. ¶ 18.
11. In December 1988, “MCC” executives expressed a desire to reduce the basic chemicals and plastics portion of their consolidated businesses to 45% by 1995, and they targeted pharmaceuticals and consumer products as the main areas for diversification. Stip. ¶ 19.
12. In 1989, “MCC” and “Abel Laboratories”, (“Abel”), a publicly held Delaware corporation with its principal place of business in (Some City), Missouri, entered into negotiations concerning “MMP”. “Abel” and its subsidiaries were involved in the development, manufacture, and sale of pharmaceutical, hospital, and laboratory products. Stip. ¶ 20.
13. On July 17, 1989, “MCC” and “Abel” entered into a stock acquisition agreement. Under the agreement, “MCC” acquired effective control of 186.3 million shares of “Abel’s” common stock (67 percent of “Abel’s” then-outstanding shares) in a two-step transaction. Stip. ¶ 21.
14. First, in September 1989, pursuant to a tender offer, “Tetra Rehab Corp.”., a wholly owned subsidiary of “MCC”, acquired 58.5 million shares of “Abel’s” common stock at a cash price of $38.00 per share. The shares represented, at that time, 38.9 percent of “Abel’s” common stock. In addition, certain principal shareholders of “Abel”

granted “MCC” irrevocable options for the purchase of their common shares and irrevocably appointed “MCC” to act as proxy in respect of their shares not purchased in the tender offer due to proration. The “Abel” shares that “MCC” acquired pursuant to the tender offer together with the shares as to which “MCC” was appointed to act as proxy gave “MCC” the power to vote 52 percent of “Abel’s” then outstanding common stock. These options and proxies expired in December 1989. Stip. 21(a)

15. Second, in December 1989, upon approval by “Abel’s” shareholders, “Abel” issued to “MCC” 127.8 million new shares of common stock in exchange for all of “MCC’s” outstanding shares of “MMP”. As additional consideration to “Abel’s” shareholders, “MCC” issued approximately 92 million contingent value rights (“CVRs”) to shareholders of “Abel” (other than “MCC”) as of December 2, 1989, on a one-for-one basis. The CVRs provided for a payment by “MCC” on September 30, 1991, to each CVR holder of a capped amount by which the average trading value of “MMM” shares of stock was less than $45.66 during the previous 90 days. As of December 2, 1989, “MCC” and its wholly owned subsidiaries owned approximately 67 percent of the outstanding stock of “MMM”. Stip. 21(b).
16. After “Abel” acquired “MMP”, Abel’s name was changed to “Minnesota Multiphasic Montrose, Inc.” The headquarters for the new company, “MMM”, remained in (Some City), Missouri, where “Abel’s” headquarters had been located. Stip. ¶ 22.
17. Through additional purchases of “MMM’s” shares during 1990, “MCC” effectively owned 190.3 million shares at year-end, or 68.8 percent, of “MMM’s” outstanding stock, of which “MCC” owned 47.6 percent and “Tetra Rehab Corp.” owned 21.2 percent. Stip. ¶ 23.

18. In 1991, “MCC” satisfied its obligation under the CVRs by paying $995 million to “MMM’s” shareholders, other than “MCC”. Further, through additional purchases of “MMM’s” shares during 1991, “MCC” effectively owned 70.01 percent of “MMM’s” outstanding stock at year-end, of which “MCC” owned 20.56 percent, “Tetra Rehab Corp.” owned 22.31 percent, and “Montrose Holdings, Inc.”, a “MCC” second-tier subsidiary, owned 27.14 percent. Stip. ¶ 24.
19. Through additional purchases of “MMM’s shares during 1992, “MCC’s effective ownership interest increased to 194.8 million shares at year-end, or 71.03 percent of “MMM”, of which “MCC” owned 23.9 percent, “Tetra Rehab Corp.” owned 20.39 percent, and “Montrose Holdings, Inc.” owned 27.35 percent. Stip. ¶ 25.
20. Through additional purchases of “MMM’s” shares during 1993, “MCC” effectively owned 71.83 percent of “MMM” at year-end, of which “MCC” owned 24.06 percent, “Tetra Rehab Corp.” owned 20.41 percent, and “Montrose Holdings, Inc.” owned 27.36 percent. Stip. ¶ 26.
21. “MMM” and its subsidiaries were involved in the development, manufacture, and sale of prescription and over-the-counter pharmaceutical products as well as products for hospital use. “MMM’s” product base was concentrated in three therapeutic healthcare segments: cardiovascular, respiratory, and gastrointestinal. Stip. ¶ 34.
22. “MMM” and its subsidiaries operated exclusively in one industry segment, pharmaceuticals, and maintained three business units – Prescription Products Division, Consumer Products Division, and International Division. Stip. ¶ 35.
23. The “Montrose Research Institute (“MRI”) located in (Some City), Ohio, had coordinated and directed the activities of “MMP’s” research centers in (various cities

in the United States, Europe and Asia) "MRI" focused on discovery, development and registration of new products, and modifications of existing products. Stip. ¶ 36.

24. On December 2, 1989, "MCC" and "MMM" entered into a Master Service Agreement which was in effect from December 2, 1989 through 1993. Ex. No. 59; Ex. No. 276, Int. No. 24. The Agreement states "MMM" "desires to avail itself of certain services, including the services of certain persons in the employ of "Montrose" who have specific management, professional and technical skills relating to "MMP" Business…" Ex. No. 59, p. 2; (1st agreement). This enabled "MMM" and "MMP" to continue the "MMP" business after December 2, 1989. Ex. No. 59.

25. "MCC" and "MMP" also entered into a Master Service Agreement on December 2, 1989. Ex. No. 59; (2nd agreement). The "MCC" and "MMM" agreement incorporated by reference the terms of the Master Service Agreement between "MCC" and "MMP". Ex. No. 59.

26. The Master Service Agreement covered the following services: manufacturing, accounting, statistical, financial, treasury, risk management, tax matters, reporting services to government agencies etc., legal services, technical services, research services, information management services, leasing of equipment services, program services, environmental waste disposal services, internal audit services, and other such services as required. Ex. No. 59 (2nd agreement), pp. 3-7; *see also* Appendix A.

27. "MCC" actually provided "MMM" (and/or its subsidiaries) with numerous services during the years at issue including: information systems, insurance coverage, retirement plans, purchasing services, payroll services, tax services, audit services, legal services, and other miscellaneous services. *See*, Ex. No. 274, Int. No. 76; Ex. No. 276, Int. No. 22; Ex. No. 40, p. 43; Ex. No. 229-230; Ex. No. 258-260.

28. "MMM" and its subsidiaries (including "MMP") were expressly excluded from the coverage of "MCC's" Authorization Policy. Supp. Stip. ¶ 6.

29. The Master Service Agreement provided that "MMP" should reimburse "MCC" for services provided. Continuous services were charged to "MMP" based on a "measurable units of effort." Ex. No. 59, p. 8. Incidental services were charged to "MMP" "at actual cost." Ex. No. 59, p. 9.

30. "MMM" and its consolidated subsidiaries had inter-company expenses for services allocated from "MCC" to "MMM" or from "MMM" to "MCC" based upon effort, where measurable, or standardized allocation formulas consistent within "MCC". Ex. No. 37, p. 40; Ex. No. 12, p. 10.

31. "MCC" provided substantial inter-company services to "MMM" and its subsidiaries, especially "MMP". "MMM" expended $53 million for services purchased from "MCC", including insurance coverage, which was approximately 6.9% of all of the selling, general, and administrative expense incurred by "MMM" in 1990 on a consolidated basis. Ex. No. 37, pp. 30, 40-41; Ex. No. 12, pp. 10, 11.

32. During the month of December 1989, "MMM" incurred approximately $3,000,000 for general and administrative services provided by "MCC" to "MMM" or "MMP". Ex. No. 194, pp. 10-11.

33. Pursuant to the Employee Seconding and Transfer Agreement, "MMM" paid $8.5 million to "MCC" for services rendered from December 1, 1989 through December 30, 1989. Ex. No. 12, p. 19.

34. On December 2, 1989, "MMM" and "MCC" entered into a Compound Exchange and Technology Interaction Agreement. Stip. ¶ 48. The Compound Exchange Agreement allowed "MMM" and "MCC" access to compounds, concepts and technology in the

possession of each other for evaluation of product development and use. Ex. No. 69, p. 2. "MMM" agreed to provide "Montrose Agriculture", an agricultural products business formed by "MCC" and "Dudley Pharmaceuticals", with certain compounds discovered or obtained by it. Ex. No. 69, p. 2. Sec. 2.1. Under the agreement, collaborative efforts were to be made in the filing of patent applications, patent validity and infringement review and patent litigation. Ex. No. 69, p. 8, Sec. 3.6.

35. On May 3, 1990, "MCC" and "Master Petrol Co." entered into a license agreement concerning a recombinant yeast expression system useful in human pharmaceuticals. Ex. No. 77; Attach. A.

36. Effective September 15, 1990, "MCC" and "MMP" (through "MRI) entered into a sublicense agreement concerning this yeast expression system. Ex. No. 77; p. 1; Ex. No. 278, Resp. No. 8. "MRI paid "MCC" ½ of the $75,000 "MCC" was required to pay to "Master"; 3% of "MRI's" net sales and ½ of the $30,000 annual license maintenance fee that "MCC" was required to pay to "Magnum". Ex. No. 77, p. 3. No royalties were paid under the sublicense. Ex. No. 278, Resp. No. 8.

37. Effective July 1, 1992, "MCC" and "MMM" entered into a Collaborative Research Agreement relating to research of water-soluble polymers with anionic groups along the backbone which have anti-HIV and anti-HSV activity. Ex. 78, p. 1; Stip. ¶ 57. This Agreement was in effect throughout 1993. Ex. No. 79. The Agreement acknowledges "MCC's" expertise in research concerning low molecular weight water-soluble polymers with anionic groups along the backbone. Ex. No. 78, p. 1. The companies were to cooperate in the research and preparing written proposals. Ex. No. 78, p. 4. Information was exchanged pursuant to this agreement. Ex. No. 80. Per the agreement, "MMM" agreed to pay "MCC" $80,000 for each compound and

$100,000 for analytical services associated with the project. Ex. No. 78, p. 6, Sec. 3.1.

38. On December 17, 1993, “MCC” sold its Toxicology Lab to “MMM”. “MCC” paid “MMM” an aggregate purchase price equal to the “net book value for assets as of the closing date which amount is estimated to be approximately $8,500,000.” Ex. No. 81, p. 2.

39. Pursuant to a Supply Agreement dated January 1, 1990, “MCC” manufactured and supplied the following active chemicals to “MMP” for use in pharmaceuticals: (i) "Drug #1"; (ii) "Drug #2"; "Drug #3" (iii) ; and (iv) "Drug #4". Stip. ¶ 53.

40. During the audit period, “MCC” sold five of its buildings in (Some City), Michigan “the 111 block” to “MMM”. Tr. pp. 490, 492; Ex. No. 75, p. 1. “MMM” paid approximately one-half of the building’s replacement cost. Tr. p. 492 (“John Doe’s” Testimony).

41. During 1990 through 1993, “MCC” provided 15 to 20 percent of “MMM’s” active pharmaceutical ingredients on either a contract manufacturing or supply agreement basis. Tr. pp. 488; 514-515, 517. This amounted to 2.25 to 4 percent of the total products purchased. Tr. p. 517 (“Doe’s” Testimony).

42. “MCC” was “MMM’s” second largest supplier of pharmaceutical ingredients during the audit period.

43. During the audit period, “MCC” manufactured "Drug #1", an active pharmaceutical ingredient, and provided it to “MMM”. Initially, “MCC” sold this "Drug #1" to “MMM” under a supply agreement, it later converted over to a contract manufacturing agreement. Tr. p. 482. Under the supply agreement “MCC” owned the facility and “MMM” owned the product. Under the manufacturing agreement,

"MMM" owned the product and the facility and "MCC" provided the manufacturing service. Tr. p. 482.

44. During 1990 through 1993, "MCC" was one of the suppliers to "MMM" for ingredients in the product "Name Brand", a product sold by "MMM". Tr. p. 509.

45. During the audit years, "MCC" was the sole supplier of "florocal", the active pharmaceutical ingredient of "Butamine", a drug product sold by "MMM". Tr. p. 510. During the audit period, "MCC" was the only company producing "florocal". Tr. p. 511. The patent on "florocal" was owned by "MMM". Tr. p. 511.

46. Prior to the merger in December, 1989, "MCC" manufactured "florocal" for "MMP". Ex. Nos. 28, 29 and 37. "Florocal" was the active ingredient for a drug called "Ambistic". Ex. Nos. 28, 29 and 37.

47. "MMM" and/or "MMP" continued to sell products sold by "MMP" prior to the merger in December of 1989. The drugs included: "Actizol", "Nipozine", "Butamine", "Cartazol", "Zambizin", "Snifsuol", "Romulac", "Tapudol", "Tripartitizine", ""Tricinosine", "Chlorizine", "Nomunil", and "Cocopuffin". Ex. Nos. 28, 29 and 37.

48. During 1989 and 1990, 80 percent of the chemical manufacturing and synthesis at "MCC's 111 building in (Some City), Michigan was for pharmaceutical chemicals. Tr. pp. 511, 512. During 1990 and on, 100% of the chemical manufacturing and synthesis at the 111 building was for pharmaceutical chemicals. Tr. p. 512.

49. The "Abel Multiphasic Montrose Research Institute" ("AMMRI") was one of "MMM's" research organizations. Tr. p. 513. During the audit period, the "AMMRI" would discover an active pharmaceutical ingredient and request that "MCC's" process research group develop the process to provide the clinical supplies.

Tr. p. 513. Employees with the process research group helped "AMMRI" assemble data for "MMM"'s filings with the FDA. Tr. p. 514.

50. "MCC's" general ledgers provide that "MCC's" total sales to "MMM" and its consolidated subsidiaries, including "MMP", were:

1990	1991	1992	1993
$40,260,519	45,749,332	19,735,511	777,463

Stip. ¶ 7.

51. As reported on "MCC's" U.S. Form 1120's, "MCC's" gross receipts or sales, less returns or allowance, were:

1990	1991	1992	1993
$7,470,627,359	6,866,997,154	6,737,969,233	6,842,317,436

Stip. ¶ 8.

52. The total purchases by "MMM" and its consolidated subsidiaries (including "MMP"), as reported on line 2 of Schedule A (Cost of Goods Sold) of "MMM's" Federal income

tax returns, were:

1990	1991	1992	1993
$614,944,665	993,571,517	1,322,514,111	427,252,634

Stip. ¶ 9.

53. During the period 1988 through 1990, "MCC" received dividend income as reported on its IL-1120-Xs. *See,* Supp. Stip. ¶¶18-37. "MCC" claimed certain dividends received by it in 1988 through 1990 were non-business income. *See,* Supp. Stip. ¶¶18-37; Ex. 1; Ex. 2; Ex. 4 (Sched. NB). Many of the dividends claimed by "MCC" as non-business income were reclassified by the Department as subtraction

modifications and therefore are not at issue. Supp. Stip. ¶ 38. The auditor classified the remaining dividends for 1988 through 1990 as business income. Ex. No. 11, p. 4; Ex. 13, Sch. III.

54. In 1988 and 1989, "MCC" did not claim any capital gain income as non-business income on its original IL-1120s or on its IL-1120-Xs. Ex. 1, 2 (Sched. NB); Supp. Stip. ¶ 31.

55. "MCC" did properly protest the auditor's adjustment of its 1990 capital gain income business income. Ex. 11, p. 4; Ex. 13, Sched. III; Supp. Stip. 32; Ex. 4 (Sched. NB).

56. Taxpayer concedes that all income from Montrose Schickelgruben", "Montrose Coppeldon", and other companies in which it holds more than a 5% interest, is business income. Taxpayer's Brief, pp. 64-65.

CONCLUSIONS OF LAW:

I. Unitary Business Group Issue

A unitary business group is defined by Illinois statute as:

> A group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other . . . Unitary business activity can ordinarily be illustrated where the activities of the members are (1) in the same general line (such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation or finance); or (2) are steps in a vertically structured enterprise or process (such as the steps involved in the production of natural resources, which might include exploration, mining, refining, and marketing); and, in either instance, the members are functionally integrated through the exercise of strong centralized management (where, for example, authority over matters such as purchasing, tax compliance, product line, personnel, marketing and capital investment is not left to each member) . . . .
>
> 35 **ILCS** 5/1501(a)(27)

Further, Department Regulation 100.9700(g) states in relevant part that:

> Under IITA Section 1501(a)(27), no group of persons can be unitary business group unless they are functionally integrated through the exercise of strong centralized management… The exercise of strong centralized management will be deemed to exist where authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member. Thus, some groups of persons may properly be considered as constituting a unitary business group under IITA Section 1501(a)(27) when the executive officers of the persons are normally involved in the operations of the other persons in the group and there are centralized units which perform for some or all of the persons function which truly independent persons would perform for themselves. . .

86 Ill. Admin. Code Sec. 100.9700(g).

A. Common Ownership

Common ownership is defined as "the direct or indirect control or ownership of more than 50% of the outstanding voting stock of the persons carrying on unitary business activity." 35 **ILCS** 5/1501(a)(27). It is undisputed that from 1990 through 1993, "MCC's direct and indirect ownership in "MMM" gradually increased as follows: 67% as of 12/31/89, 68.8% as of 12/31/90, 70.01% as of 12/31/91, 71.03% as of 12/31/92, and 71.83% as of 12/31/93. Stip. ¶¶21-26. Thus, the common ownership requirement in Section 1501(a)(27) of more than 50% was clearly met.

B. Same General Line of Business

It must then be determined whether "MCC" and "MMM" are in the same general line of business, i.e., pharmaceutical manufacturing, research and development. Section 100.9700(h)(2) states that two persons will ordinarily be considered to be in the "same general line of business" under Section 1501(a)(27) if they are both involved in one of the following activities:

A) manufacturing
B) wholesaling
C) retailing
D) insurance

E) transportation, or
F) finance.

86 Ill. Admin. Code Sec. 100.9700(h)(2)

Section 100.9700(h)(4) states that IITA Section 1501(a)(27) does not require that the activities of the two persons in a category relate to the same product or product line in order for the two persons to be in the same general line of business.

Taxpayer argues that "MCC" and "MMM" are not engaged in the same line of business because "MCC" does not manufacture or market finished pharmaceutical products. It contends that "MCC" should be solely classified as a manufacturer of bulk chemicals. Taxpayer's Brief p. 7. In support thereof it argues that "MCC" and "MMM" operated in two entirely distinct industries, with different economic circumstances and needs in terms of talent, technology, capital investment, and the like. Taxpayer Brief p. 14.

"MCC" manufactured and supplied pharmaceutical ingredients both before the December 2, 1989 merger and after, a period that includes the entire audit period. Ex. No. 26, Sec. 7.23, p. 60, Sched. 3.13; Ex. No. 69, p. 7, Sec. 3.3. First, the Stock Acquisition Agreements between Abel and "MCC" expressly permitted "MCC" and its subsidiaries to continue to engage in "process research and development, and basic research and development relating to pharmaceutical products." Ex. No. 26, Sched. 3.13; Ex. No. 27, p. 35. Although "MCC" may well have been primarily engaged in chemical manufacturing, it had a significant pharmaceutical business during the period at issue. Between 80%-100% of "MCC's" "111 building" was devoted to pharmaceutical chemicals, a building which employed 65 individuals in the manufacture of

pharmaceutical chemicals. Tr. pp. 481, 511-512. (Testimony of "John Doe", Former Section Manager of Pharmaceutical Chemicals at "MCC" ("Doe")).

The taxpayer also contends that the sole pharmaceutical operations that "MCC" retained after the merger were merely those related to certain Latin American subsidiaries. Taxpayer's Brief pp. 11, 16. In fact, "MMM" and/or "MMP" continued to sell many of the same products that "MMP" sold prior to the merger, products for which "MCC" manufactured the active pharmaceutical ingredients and included "MMP" in its unitary business group in its IL-1120s. Ex. No. 28, p. 7; Ex. No. 29, p. 6; Ex. No. 37, pp. 6-15, 27, *see also*, Ex. Nos. 1, 2, 3 (Sched. UB). After the merger, "MCC" continued to manufacture the active pharmaceutical ingredients in (Brand Name Products) at "MCC's" (Some City), Michigan location. Tr. pp. 474-476; 508 ("Doe"). "MCC" manufactured these ingredients for "MMM's" finished pharmaceutical products. Tr. pp. 509, 510 ("Doe"). In fact, "MCC" was the second largest source of pharmaceutical supply to "MMM". Tr. p. 625 (Testimony of "Richard Roe", former President, Chief Executive Officer, and Chairman of the "MMM" Board, and Director on the "MCC" Board ("Roe")).

"MCC" points out that it also manufactured an inactive pharmaceutical ingredient for "MMM's" finished pharmaceutical products as well as to other companies for non-pharmaceutical use. The fact that Methylcellulose, for example, was sold to other companies besides "MMM" for use in paints, barbecue sauces, cake mixes, and chocolate shakes, as well as for finished pharmaceuticals is irrelevant. The fact remains that "MCC" actively manufactured this ingredient for "MMM's" use as an excipient in finished pharmaceutical products throughout the audit period. The evidence at hearing proves that "MCC" developed, manufactured and supplied pharmaceutical ingredients

and excipients, and "MMM"/"MMP" developed, manufactured and sold pharmaceutical products. The mere fact that "MCC" did not manufacture finished pharmaceutical products as did "MMM", does not preclude a finding of unity since Section 100.9700(h)(2) specifically states that Section 1507(a)(27) does not require that the activities of "MCC" and "MMM" in the manufacturing category relate to the same product or product line to be in the same general line of business.

C. Vertical Integration

Further, "MMM's" and "MCC's" operations were vertically integrated as evidenced by "MCC's" manufacture and supply of required pharmaceuticals to "MMM" for "MMM's" manufacture and sale of finished pharmaceutical products. "MMM's" 1190 Form 10-K, states as follows:

> The loss of any single source of supply for "MMM", other than "Montrose", […..] would not have a material adverse effect on "MMM's" business.

Ex. 50, "MMM's" 1990 Form 10-K, at 6; *See also*, Ex. No. 51, p. 5; Ex. No. 52, p. 8; Ex. No. 53, p. 8. Thus, it is clear that "MCC's" supply of required pharmaceuticals to "MMM" was significant and necessary. Further evidence of vertical integration exists in that during the audit period, "MCC" was the sole supplier of "Putadine", the active ingredient of "Butamine".

D. Functional Integration and Strong Centralized Management

"MCC's" pharmaceutical business and "MMM's" pharmaceutical business were also functionally integrated through strong centralized management and substantial intercompany transactions. The record reflects the following: (1) "MCC" and "MMM" had approximately 4 overlapping directors at one time. Each of these individuals was also an officer of one of the companies, Stip. ¶¶ 67-70; (2) seventeen of the 37 "MMM"

executive officers were previously employed with "MCC" and/or its subsidiaries, Stip. ¶70; (3) the "MMM" officers that were authorized to enter into contracts with "MCC" in December 1989 were also "MCC" directors, Ex. No. 195; Stip. ¶ 70; (4) two of the three signatories on the Master Service Agreements were interlocking directors, Ex. No. 59; (5) three of the overlapping "MCC"/"MMM" directors were on the "Montrose" Management Committee, Ex. Nos. 29, 30, 31; and (6) during the transition period (September-December 1989), six "MCC" directors were placed on "Abel" Laboratories' Board. Ex. No. 29, p. 21.

Taxpayer emphasizes the fact that there were no overlapping officers during the audit period and, further that "MMM" had separate departments for its administrative functions and was not required to seek authorization from "MCC's" Board of Directors. These statements in fact, are true, however, while these factors are indicia of centralized management, the lack thereof does not preclude a finding of unity in this matter given the strong evidence that the business operations of "MMM" and "MCC" were functionally integrated during the audit period. The court in A.B. Dick v. McGaw, 287 Ill. App. 3d 230(4th Dist. 1977) has stated that "If functional integration has been shown, or if strong centralized management has been shown, then there is a unitary business. Id., at 233.

1. Intercompany Sales of Pharmaceutical Ingredients

An analysis of the record reveals that there was strong evidence of functional integration. First, there were a significant number of inter-company transactions between "MCC" and "MMM" and their subsidiaries. Total sales from "MCC" to "MMM" and its subsidiaries were as follows: $40,260,519 in 1990; $45,749,332 in 1991; and $19,735,511 in 1992; and $777,463 in 1993. Stip. ¶ 7.

Further, "MCC" supplied "MMM" with approximately 15 to 20 percent of "MMM's" active pharmaceutical ingredients. Ex. Nos. 1-10. Taxpayer's Initial Memorandum of Law mistakenly states that "MCC" manufactured no more than between 2.25 and 4 percent of all active ingredients purchased by "MMM" for its finished pharmaceutical products. Taxpayer's Initial Brief at 29 and 57. (Taxpayer noted this error in its Reply Brief p. 12). While acknowledging that "MCC" sold "MMM" 15 to 20% of "MMM's" active pharmaceutical ingredients in its reply brief, taxpayer emphasizes that this only constitutes between 2.25 and 4 percent of all ingredients (active and inactive) in "MMM's" finished pharmaceutical products, therefore, the sales are insignificant. Taxpayer's Brief p. 12 & Tr. pp. 514-15 ("Doe's" testimony) and Ex. No. 298 (chart).

These inter-company sales, however, are significant for the following reason. Taxpayer acknowledged that a finished pharmaceutical product typically consists of between 20 – 25% of an active ingredient and between 75 – 80% of an inactive ingredient. It is the active ingredient that actually produces the desired medical result. The inactive ingredient is necessary to aid absorption of the active ingredient or to buffer the effects on the body. Tr. p. 477-79 (Price's testimony); Ex. No. 298. Given that a finished pharmaceutical product is primarily comprised of inactive ingredients, it is not surprising that "MMM's" purchases of active ingredients would represent a smaller percentage of its total purchases than its purchases of active ingredients for that same year. Thus, it is very significant that "MCC" sells "MMM" approximately 15 to 20% of "MMM's" active pharmaceutical ingredients. Further, while "MMM" dealt with numerous suppliers during the audit period, "MCC" was its second largest supplier during that same time. Tr. p. 625 ("Roe's" testimony). Therefore, sales of 15-20% of

"MMM's" active pharmaceutical ingredients represents strong evidence of functional integration.

2. Centralized Management

Secondly, there is evidence of oversight by "MCC's" Management of "MMM" activities. For example, "Josh Mostel" ("MCC" and "MMM" Director and CEO of "MMM") and "Richard Roe" ("MCC" and "MMM" Director and President/CEO of "MMM") regularly reported to "MCC's" Board of Directors regarding "MMM" activities throughout the 1990 through 1993 years. The reports covered the status of various "MMM" (and "MMP") pharmaceutical products, such as: the FDA status of the drug application for "Actiphaze" and "Actiphaze-B", including profiles and reviews of sessions between "MMM" and the FDA (Ex. Nos. 161, 164, 165, 168, 179, 180, 182); the FDA status of the drug application for "Nicorea" (Ex. No. 174); various "MMM" products (Ex. No. 173, 184, 190); product developments regarding "Cortizone CD", the ("Name Brand") family of products, and the ("Name Brand #2") family of products (Ex. No. 189); distribution of "MMM" press releases regarding "MMM" products or "MMM" partnership formations (Ex. Nos. 171, 179, 180); a slide presentation of "MMM"RI patents covering 1982 through 1990 (Ex. No. 166); an agreement between "MMM" and (another company). regarding a new drug (Ex. No. 167); new products earning FDA approval (Ex. No. 175); review of an advertising promotion dispute regarding (drug) (Ex. No. 181); review of "MMM"'s plans for launching "Nicorea" in the U.K. (Ex. No. 182).

The reports also given to the "MCC" Board of Directors related to "MMM" (and "MMP") operations and management activities, included: quarterly reports and financial highlights of "MMM" (Ex. Nos. 160, 165, 174, 168, 167, 176, 178, 183, 184, 190); the addition of a member to the "MMM" Board of Directors (Ex. 161); pharmaceutical

industry reporting practice (Ex. No. 1640; “MMM”’s reduction of capital program (Ex. No. 164); the “MMM” global strategy process (Ex. No. 165); “MMM”’s loss of a state court proceeding regarding "B" (Ex. Nos. 173, 174); review of the “MMM” insider trading policy for directors (Ex. Nos. 174); developments in the international area, global marketing concept changes and refinements and improvements in organizational effectiveness (Ex. No. 175); description of a “proposed business arrangement under consideration by “MMM”I management” (Ex. No 177; *see also* Ex. 179); review of financial data, support programs, and strategic goals for major products 9Ex. No. 182); distribution of a booklet on “MMM””s position on healthcare reform (Ex. No. 185); distribution of an “MMM” publication, “Insight” (Ex. No. 186, 187); review of workforce reduction at “MMM” (Ex. No. 189) and the impact of it on research and development at "City #1", and "City #2"" (Ex. No. 188); discussion of senior management changes (Ex. No. 189); and “MMM”’s strategy of successfully doing business in health care (Ex. No. 189). "Witness" also gave “highlights” from two European trips he participated in with “MMM” research teams. Ex. Nos. 176, 184).

Further, “MCC”’s Board of Directors committees also reviewed various “MMM” activities during the audit period. The Audit Committee of the “MCC” Board of Directors regularly reviewed the auditing function at “MMM”. Ex. Nos. 109-115. The Environment, Health & Safety committee of “MCC”’s Board frequently reviewed the safety performance of “MMM”, including discussions relating to: “MCC”’s and “MMM”’s agreement to the EPA’s voluntary Toxins Release Inventory Reduction program on April 10, 1991 (Ex. 91); “MMM”’s motor vehicle safety training on January 8, 1992 (Ex. 93); an accident occurring to an “MMM” employee, and the improvement of “MMM” frequency rates on February 12, 1992 (Ex. 94); overview of environment, health

& safety activities in “MMM” and three other companies on May 13, 1992 (Ex. 96); replacement of “MMM” Vice President of Environment, Health & Safety on September 9, 1992 (Ex. 97); “MMM” (City) Center’s receipt of the 1992 Regional Albert Thomas Prize from the French Labor minister on April 7, 1993 (Ex. 98); “MMM”’s presentation of its Global Safety Awards for 1992 on May 12, 1993 (Ex. 99); flood damage to “MMM”’s (City & Country) site under its “Reportable Loss Performance” discussion on October 13, 1993 (Ex. 101); and financial highlights; changes in the “MMM” senior management; reporting practice, strategy processes; pending legal proceedings; marketing strategy; business proposals under consideration; “MMM” publications and positions on healthcare; workforce reduction issues; and research issues.

3. Research and Development

“MCC” produced at least six ingredients for “MMM”’s pharmaceutical products: Ex. No. 276, p. 1, Int. No. 1; Ex. No. 74; Stip. 53; Tr. pp. 474-475.

“MMM” was dependent upon “MCC” for its manufacture of pharmaceutical ingredients. “MMP” would not have been able to produce one of its products, without “MCC’s" production of (drug) because “MCC” was the sole manufacturer of (drug). Ex. No. 49, p. 5; Tr. pp. 510, 511. "Drug #1" was a significant product for “MMM”: “MMM”’s consolidated net sales of [it]were 3.1% of its 1990 sales. Ex. No. 37, p. 30. In addition, “MMM” benefited by using “MCC” as a supplier since the price of all the “MCC”-produced raw material used by “MMM” in its products under the 1990 Supply Agreement was based on the lowest available U.S. market price or a mutually agreed price. Ex. No. 75, p. 11.

Further, flows of value existed beyond the price charged for these transactions. “MCC” was the sole producer and supplier of "Drug #1" for “MMP” prior to the merger

and continued to be such after the merger. This continuity of supply of "Drug #1" to "MMM" resulted in significant savings in transaction costs because "MMM" could rely on "MCC" as a known source of supply. "MCC" was also already familiar with the business needs of "MMP" with regard to "Drug #1" since it supplied this chemical to "MMP" prior to December of 1989. This continuing relationship also resulted in flows of knowledge since "MCC" possessed a certain expertise from its prior experience of supplying the ingredients to "MMP". Further, "MCC" not only continued to produce (drug) after the merger, it continued to act as one of the suppliers for the active ingredients in (13 separate name brands) Ex. Nos. 28, 29 and 37. Thus, "MMM" clearly reaped the benefits from this significant business arrangement.

Taxpayer argues that ""MMM" held the patents on all active ingredients and processes that "MCC" was providing and could have found another supplier if its relationship with "MCC" soured." It is true that "MMM" did acquire the patents to this ingredient from "MMP" upon the merger. The fact remains, however, that "MMM" did not seek other suppliers because of the significant flows of value as well as significant economies of scale achieved by "MCC" continuing to supply these active ingredients. *See,* Mobil Oil Corp. v. Commissioner, 445 U.S. 425, 438, 100 S.Ct. 1223 (1980) and Exxon Corp., 447 U.S. 207.

This strong relationship is further reflected when in 1992, "MCC" authorized construction of a Multi-Product Bulk Pharmaceutical Manufacturing Facility and Pilot Facility so that "MCC" would "become the preferred supplier of bulk pharmaceuticals to Abel, Inc." Ex. No. 139 (000018). The facilities were designed to strengthen the relationship between "MMM" and the Michigan Division and align the organizational

structure for manufacturing bulk pharmaceuticals in the Michigan Division. Ex. No. 139 (000019).

4. Intercompany Sales of Other Assets

There were also substantial intercompany sales of assets other than pharmaceutical ingredients. During the audit years "MCC" and "MMM" (and/or "MMP") entered into at least three sale agreements during the audited tax years relating to pharmaceutical assets: 1) April 1, 1992 Purchase Agreement for the Pharmaceutical Manufacturing and Research Facilities (Ex. No. 75); 2) April 1, 1992 Manufacturing Agreement (Ex. No. 76); and 3) December 17, 1993 Asset Purchase Agreement (Ex. No. 81). "MCC" sold certain pharmaceutical assets to "MMM" and operated those facilities on behalf of "MMM" under the first two agreements. Ex. Nos. 75, 76. Under the 1993 Asset Purchase Agreement, "MCC" purchased the assets of "MMM's" toxicology laboratory and agreed to provide "MMM" with toxicology support. Ex. No. 81, p. 1. "MCC" paid "MMM" a total purchase price equal to the "net book value of the Assets as of the Closing Date which amount is estimated to be approximately $8,5000,000." Ex. No. 81, p. 2.

5. Intercompany loans

Taxpayer also argues that the intercompany loans made throughout the period were occasional and insignificant. The evidence reveals otherwise. The following were loans during the audit period: (1) Lira 24,949,201,465 loan from "MMM" to "MCC" from April 26, 1989 through April 26, 1991; Ex. No. 62. "MCC" was obligated to pay interest "at the Lira three month rate as displayed on the Reuters or TeleRate video monitor services minus 1/8% for the term of such Advance. Ex. 62, Section 1.05(a); (2) On December 28, 1989, "MMP's" Executive Committee authorized a $70 million loan to

"MCC" for two weeks. Ex. No. 191; Ex.. No. 12, p. 10; Ex. 274 Nos. 45 & 47; (3) "MCC" had $19,645,041 in long-term debt to "MMP" as of December 31, 1989; Ex. No. 274, Int. Nos. 45 & 47; (4) $189 million of which matured in 1990 Ex. No. 194, p. 11; (5) "MMM's" loan of $275 million to "MCC" on December 28, 1990, to be repaid on January 2, 1991; Ex. No. 61; (6) "MCC's" note payable to "MMP" in the amount of $13.5 million as of December 31, 1990 (Ex. No. 274, Int. Nos. 48 and 47); and (7) "MCC's" year-end short-term borrowings from "MMM" of $415 million in 1991, $230 million in 1992, and $175 million in 1993 (Ex. No. 38, p. 48; Ex. No. 39, p. 40; Ex. No. 40, p. 42).

The evidence also shows that (1) "MMM" had an unused revolving credit line with "MCC" for $75 million as of July 21, 1989, which was provided at no cost; Ex. No. 27, p. S-11, Ex. No. 194, p. 11; (2) as of December 31, 1989, "MMM" had unused credit lines with "MCC" in the aggregate amount of $106 million, for which "MMM" incurred no charge; Ex. No. 194, p. 11; (3) "MCC" had a revolving credit agreement with "MMM" up to $500 million. Ex. No. 20, p. 2; Ex. No. 23, p. 3; Ex. No. 169; (4) a note receivable from "MMP" in the amount of $20.9 million as of December 31, 1990 (Ex. No. 274, Int. Nos. 45 and 47); (5) "MCC's" authorization for its subsidiary to lend $70 million to an "MMM" subsidiary on May 9, 1991 (Ex. No. 169, p. 7); and (6) "MCC's" guaranty of "MMM's" obligations relating to (subsidiary); Ex. Nos. 85-87; Ex. No. 188.

Both parties benefited from the foregoing inter-company debt transactions. For example, interest paid by "MCC" for the April 26, 1989 agreement was based on the market rate less 1/8%. Ex. No. 62, Section 1.05(a). "MMM" was not charged for its revolving credit facilities – one for $75 million (which expired in July 1990) and an aggregate amount of $106 million. Ex. No. 27, p. S-11; Ex. No. 194, p. 11.

Additionally, each company benefited from the availability of the funds. "MCC" used the $275 million loan obtained from "MMM" in December 28, 1990 to reduce its third-party short-term debt. Ex. 12, p. 10. "MMM" also benefited from "MCC's" guarantee of loans, for example, the (subsidiary) guaranty, which allowed outside investors to make capital contributions to "MMM's" partnership in the amount of $175 to $225 million. Ex. No. 85, p. 1. As Montrose's Vice President and Treasurer himself wrote on September 1, 1993, "The guaranty of Montrose of the "MMM" obligations will permit "MMM" to obtain investments in (subsidiary) at a lower financial cost and realize the benefits of off-balance sheet financing." Ex. No. 87.

6. Master Service Agreement

During the audit period, the parties entered into Master Service Agreement which covered the following services: manufacturing, accounting, statistical, financial, treasury, risk management, tax matters, reporting services to government agencies etc., legal services, technical services, research services, information management services, leasing of equipment services, program services, environmental waste disposal services, internal audit services, and other such services as required. Ex. No. 59 (second agreement), pp. 3-7; *see also* Appendix A. "MCC" actually provided "MMM" (and/or its subsidiaries) with numerous services during the years at issue including: information systems, insurance coverage, retirement plans, purchasing services, payroll services, tax services, audit services, legal services, and other miscellaneous services. *See*, Ex. No. 274, Int. No. 76; Ex. No. 276, Int. No. 22; Ex. No. 40, p. 43; Ex. no. 229-230; Ex. No. 258-260. "MMM" did in fact, have its own departments for many of these services, however, the evidence shows that "MMM" also obtained many services from "MCC". As noted by the Department, the Master Service Agreement even provided for the continuation of

approximately 200 existing agreements between “MCC” and “MMP”. These agreements remained “unaffected and without interruption” by the execution of the Agreements. Ex. No. 204, p. 4.

In 1990, “MMM” expended $53 million for services from “MCC”, approximately 6.9% of all of the selling, general, and administrative expense incurred by “MMM” on a consolidated basis. Ex. No. 37, pp. 30, 40-41; Ex. No. 12, pp. 10, 11. Further, although “MMP” reimbursed “MCC” for services provided under these agreements, “MCC” was not reimbursed at arm’s length rates. A flow of value was evident because continuous services were charged to “MMP” based on “measurable units of effort.” Ex. No. 59, p. 8. Incidental services were charged to “MMP” “at actual cost.” Ex. No. 59, p. 9.

Lastly, taxpayer attempted to prove that all of the transactions were conducted at arm’s length. In support of its position, it presented an expert witness to testify at hearing. Although its expert witness, "Dr. C", testified that the two companies were not unitary, the basis from which he formed his opinion appears incomplete.

In his report he wrote that he reviewed all of the stipulated documents, however, his testimony at hearing goes into his basis for specific conclusions that he made in his report and contradicts this written statement. Upon cross-examination, he admitted that his opinions were in large part based upon his one conversation with "Mr. EF". While "Dr. C" stated that he relied on the stipulation of facts and its exhibits in determining how many raw materials were purchased by “MMM” from Montrose during the audit years. (Tr. p. 811, lines 2-19), he made other very significant conclusions solely based upon a single telephone conversation with "Mr. EF".

Upon cross-examination, "Dr. C" was referred to his report and asked various questions about his conclusions. On p. 813 of the transcript, it reads as follows:

Q. … I'm now going to refer you same page, but Paragraph 7 where in states that: "Communication between members of the board of directors for […](sic) and "MMM" or "MMP" was infrequent and focused on matters such as stewardship."
A. Uh-huh.
Q. What are the bases for your conclusion that such communications were infrequent?
A. That would have again – it's in the footnote. It would have been the conversation I had with "Mr. EF".

Q. Were there any other bases –
A. No.
Q. –for your conclusion?
A. No, I don't believe so.

Tr. p. 813, line 18-24. Tr. p. 814 line 1-10.

When further questioned, Carlson stated as follows:

Q. I'm now going to refer you to Page 17 of your report.
A. 17?
Q. Yes. I'm going to refer you to the middle of your paragraph which is entitled "Vertical Integration."
A. Uh-huh.
Q. The sentence begins: ""MMM" and "MMP" did purchase some raw" – did you find that sentence?
A. Uh-huh.
Q. Within that sentence you state that there were arm's length and commercially reasonable rates. After that sentence you make no citation. What did you rely on in determining that an arm's length and commercially reasonable rate was established?
A. This was the discussion that I had with "Mr. EF".
Q. Were there any other bases for your conclusion?
A. No.

Tr. p. 815 line 5-24.

Further, although he concluded that the overall inter-company transactions were modest, he was not aware that "MCC" was the sole producer and supplier of "Drug #1", the active ingredient in (Name Brand) for "MMM" during the audit period.

Q. Are you aware that Montrose Chemical was the sole supplier of a raw material that was necessary to produce one of "MMM"'s pharmaceutical products called (Name Brand)?
A. No, I am not. If I could ask for clarification. That's a difference molecule than (Name Brand #2) I take it?
Q. It is.
A. Okay.

Tr. pp. 811 line 20-24, 812, line 1-6.

In fact, "Dr. C" did not review the board minutes, committee minutes, audit comments, lease agreements, or expense reports. Tr. pp. 807-808 ("C", Cross-Examination.) Thus, "Dr. C's" opinion as to the nature of the relationship between "MMM" and "MCC" is based upon incomplete evidence and therefore, cannot be afforded much weight.

It is not necessary to find that companies have no independent existence to find that they belong to the same unitary group. *See*, A.B. Dick v. McGaw, *supra*. Despite taxpayer's arguments that "MMM" is relatively autonomous with regards to day-to-day management, the evidence of record shows that "MCC", "MMM" and "MMP" and their respective subsidiaries were engaged in a unitary business as evidenced by: the requisite ownership, their engagement in the same general line of pharmaceutical research, development, and manufacturing business, their vertically structured operations and their functional integration through strong centralized management.

II. Business Income Issue

Section 1501(a)(1) of the Illinois Income Tax Act defines Business income as

> …income arising from transactions and activity in the regular course of the taxpayer's trade or business, net of the deductions allocable thereto, and includes income from tangible and intangible property if the

> acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

35 ILCS 5/1501(a)(1).

Non-business income is defined as "all income other than business income or compensation." 35 ILCS 5/1501(a)(13). Income is business income unless it is clearly classifiable as non-business income. 86 Ill. Admin. Code Sec. 100.301(a). Further, it is the taxpayer's burden of demonstrating that a particular item of income is non-business income. Dover Corp. v. Department of Revenue, 271 Ill. App. 3d 700, (1st Dist. 1995), reh'g denied, 163 Ill. 2d 552.

The definition of business income in Section 1501(a)(1) is comprised of two separate tests: the functional test and the transactional test. Texaco-Cities Service Pipeline Company v. McGaw, 192 Ill. 2d 262 (1998). The transactional test looks at whether the income was derived from a transaction or activity in the regular course of the taxpayer's trade or business. Dover Corp, 271 Ill. App. 3d at 711. The functional test looks at whether the role or function of the property that gave rise to the gain was integral to the taxpayer's regular business operations. Texaco-Cities, 192 Ill. 2d at 272. The functional test is not concerned with the regularity or frequency of the transaction that produced the income. Id. at 271. Further, the functional test is not limited to a taxpayer's trade or business, but includes the "operations' of its business, which include its investment activities. *See,* Kroger Co. v. Department of Revenue, 284 Ill. App. 3d 473, 479 (1st Dist. 1996), *reh'g denied*, *appeal denied*, 171 Ill. 2d 567.

Taxpayer asserts that the income at issue was derived from dividends and capital gains from shares of stock it held in various companies. Further, it maintains that these investments were temporary and were not used for any operational function.

The Department established its *prima facie* case by the introduction of the Notice of Deficiency. 35 ILCS 5/904. In attempting to demonstrate that the dividend and capital gain income is clearly classifiable as non-business income, the taxpayer relied solely on the testimony of "MCC" director/officer "Mr. EF" to establish the frequency of the taxpayer's investment activities. There is simply no documentary evidence in the record which establishes that which I may review in making my determination. Reliance on testimony alone, however, without corroborating documentary evidence is insufficient to overcome the Department's *prima facie* case. Department of Revenue v. Balla, 96 Ill. App. 3d 292.

III. Penalties

Finally, the taxpayer has requested an abatement of the penalties due to reasonable cause. The determination of whether a taxpayer acted with reasonable cause is made on a case-by-case basis, taking into account all pertinent facts and circumstances. 86 Ill. Admin. Code Sec. 700.400(b). The most important factor be considered is whether the taxpayer made a good faith effort to determine its proper tax liability and to file and pay in a timely fashion. 86 Ill. Admin. Code Sec. 700.400(b). A good faith effort will be found if a taxpayer exercised ordinary business care and prudence. 86 Ill. Admin. Code Sec. 700.400(c).

In the instant matter, the voluminous documents and the testimony of its 10 fact witnesses presented at hearing show that "MCC" exercised ordinary business care in determining its filing position for the years at issue.

Wherefore, for the reasons stated above, I recommend that the NOD at issue be finalized as follows: "MCC", "MMM" and "MMP" (and their respective subsidiaries)

were engaged in a unitary business during 1990 through 1993, the dividend and capital gain income at issue in this matter should be classified as business income, and all penalties in this matter be abated due to reasonable cause. The Claim for Refund should also be denied with respect to these issues.

Date: November 13, 2000

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Administrative Law Judge